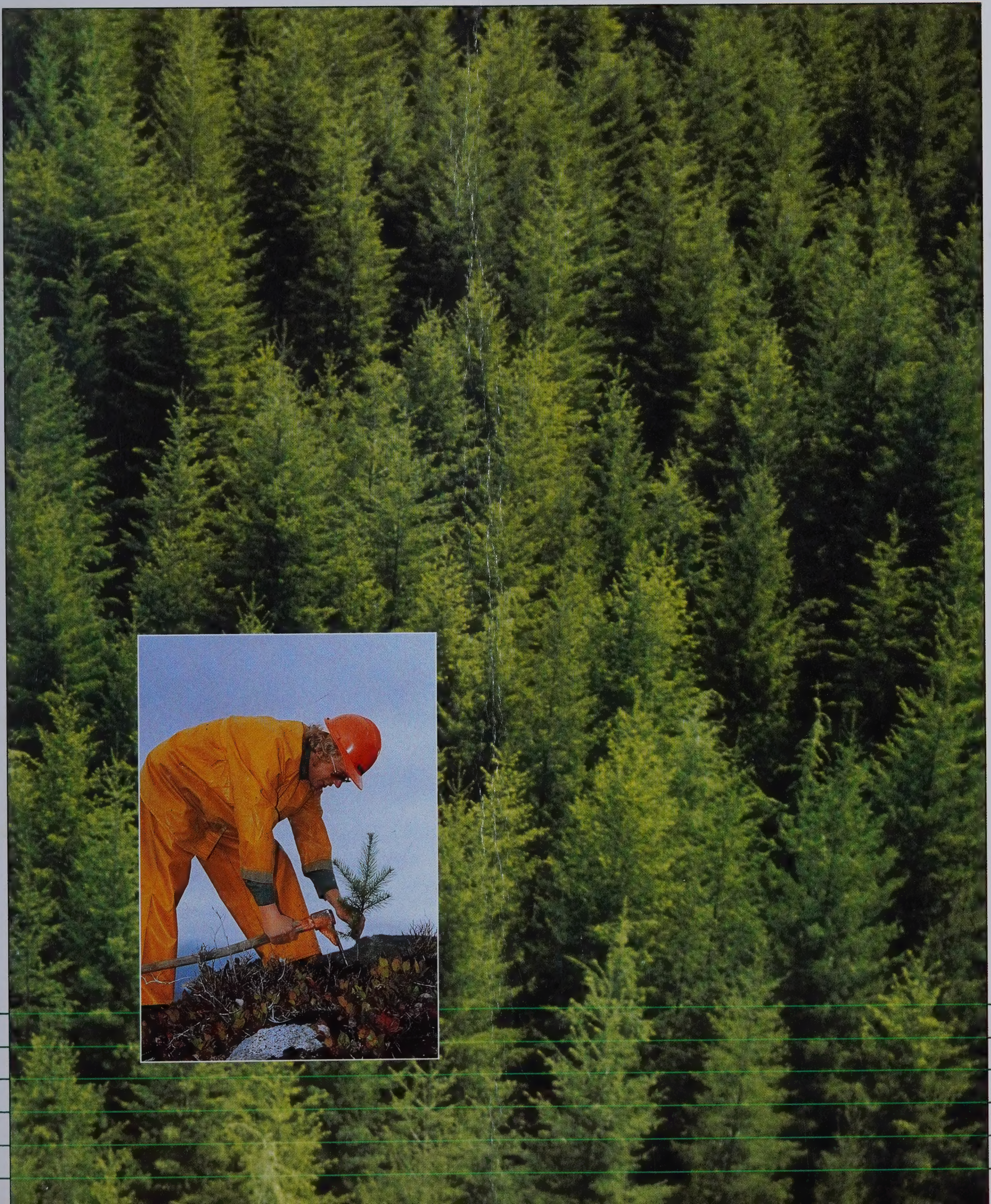
Canfor Corporation Annual Report 1985



Contents

Our commitment

We are committed to safety and job satisfaction for our employees, product quality and service for our customers and profits for our shareholders.

At Canfor, we use our customers' products whenever we can. This year, we were pleased to print our annual report on Topkote Gloss, a fine quality product from Kanzaki Paper Manufacturing Ltd. of Japan.

(COVER PHOTO) A vigorous second growth forest provides a backdrop for the planting of a Douglas fir seedling on Canfor's Tree Farm Licence 37.

(Photos by Wayne Cochrane, a Canfor Reforestation Specialist.)

Financial highlights

	1985	1984
Sales and income *(in millions of dollars)*		
Net sales	**$1,083.8**	$1,029.5
Loss before equity income and minority interests	**(54.0)**	(24.9)
Equity in income (loss) of affiliated companies	**(8.2)**	1.4
Net loss	**(61.4)**	(23.8)
Cash flow from operations	**0.8**	31.3
Per common share *(in dollars)*		
Net loss	**$ (3.67)**	$ (1.45)
Cash flow from (used in) operations	**(0.32)**	1.52
Common shareholders' equity	**11.08**	14.73
Financial position *(in millions of dollars)*		
Working capital	**$ 1.3**	$ 48.5
Total assets	**914.8**	899.6
Long-term liabilities	**198.8**	231.0
Shareholders' equity	**292.0**	359.7
Total capitalization	**519.5**	601.1
Additional information		
Return on capital employed	**(5.5)%**	(0.1)%
Return on common shareholders' equity	**(28.5)%**	(9.3)%
Ratio of current assets to current liabilities	**1.0:1**	1.2:1
Ratio of total debt to shareholders' equity	**61:39**	53:47
Capital expenditures *(in millions of dollars)*	**$ 59.5**	$ 41.0
Number of employees at year end	**6,260**	7,230
Employment costs *(in millions of dollars)*	**$ 270.6**	$ 259.5

Quarterly financial information

	1985 Three months ended				1984 Three months ended			
	Mar 31	**June 30**	**Sept 30**	**Dec 31**	Mar 31	June 30	Sept 30	Dec 31
Sales and income *(in millions of dollars)*								
Net sales	**$248.5**	**$307.4**	**$276.3**	**$251.6**	$226.4	$271.7	$282.8	$248.6
Loss before equity income and minority interests	**(17.0)**	**(7.2)**	**(13.5)**	**(16.3)**	(6.0)	(0.6)	(4.9)	(13.4)
Equity in income (loss) of affiliated companies	**(1.8)**	**(4.0)**	**(2.3)**	**(0.1)**	0.2	0.8	(1.3)	1.7
Net income (loss)	**(16.6)**	**(8.6)**	**(14.0)**	**(22.2)**	(4.7)	0.3	(5.8)	(13.6)
Per common share *(in dollars)*								
Net loss	**(0.99)**	**(0.56)**	**(0.83)**	**(1.29)**	(0.26)	(0.01)	(0.35)	(0.83)

For definitions of selected financial terms, please refer to page 33

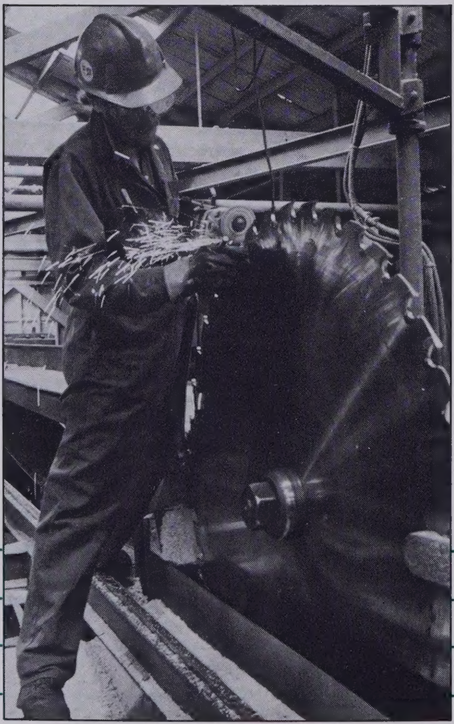
Directors' report to shareholders

EXECUTIVE REVIEW

Summary of 1985

The Company's net loss for 1985 was $61.4 million, or $3.67 per common share after provision for dividends on preferred shares. The previous year's net loss was $23.8 million, or $1.45 per share after preferred dividends. Net sales for the year were $1,083.8 million compared with 1984 net sales of $1,029.5 million.

Demand for wood products was relatively firm during 1985 but high levels of lumber production kept prices at unsatisfactory levels for most of the year in the key United States market. Offshore lumber markets also failed to show much improvement, although favorable shifts in foreign exchange rates increased returns slightly in the fourth quarter. Domestic markets for panel products strengthened, reflecting an active housing industry in Canada. This in turn benefited the Company's Canadian building materials distribution business.



The efforts of employees throughout the Company resulted in higher productivity.

In the pulp and paper sector, pulp supply continued to exceed demand, and the plunge in prices which began in mid-1984 extended into 1985. Prices declined to levels well below those of the previous year and remained extremely depressed for the balance of 1985. In addition, substantial and costly curtailments of pulp production were required to control inventories. Sack kraft demand also remained weak and prices were unsatisfactory.

The marked deterioration in pulp and paper results more than offset modest improvements in wood products and building materials and was a major cause of the Company's loss. Also, significant non-recurring losses and severance costs were incurred during 1985 as actions were taken on numerous fronts to reduce operating costs, reallocate resources and restore profitability.

Despite the negative impact on earnings of these actions, they represented positive progress on the recovery strategy outlined in the 1984 annual report:
- to divest for debt reduction;
- to restructure and rationalize;
- to invest in high return projects within the Company;
- to remain a leader in quality, productivity, safety, innovation and customer service.

During the first half, the Company's interest in Yorkshire Trust Company was sold for $10.6 million. The major portion of Canfor's shares in Versatile Corporation was also sold during this year, yielding net proceeds of $33.4 million.

At mid-year, the Company acquired working interests in certain oil and gas properties. After servicing and retiring the related short term indebtedness, Canfor will realize a significant incremental cash gain, most of which will be received during 1986.

Subsequent to year-end, the Company agreed to sell its shares in Balco Industries Ltd. for net proceeds of $10.2 million which will be used to reduce short-term bank indebtedness. The sale is subject to approval by the Minister of Forests and is expected to close at the end of April. In addition to the debt reduction from the sale proceeds, the transaction will eliminate approximately $13 million of Canfor's consolidated debt which is attributable to Balco. The sale is not expected to disrupt existing arrangements with Balco on forestry and the marketing of plywood and lumber.

Several changes were made during 1985 to restructure manufacturing and distribution facilities. The Canadian building materials organization was rationalized and is now comprised of three regions and 21 distribution centres, compared with five regions and 28 centres previously. Also, Canfor U.S.A. Corporation realigned its facilities and market emphasis to meet changing business requirements.

Other action is underway to make this subsidiary profitable. The Plywood and Hardboard Division's unprofitable New Westminster plywood mill was permanently closed at the end of October and the related assets are in the process of being sold. The neighboring hardboard plant continues to operate and is now known as the New Westminster Hardboard Division. In Alberta, the assets of the Chisholm lumber operation were sold. In addition, other surplus and non-essential property and equipment have been sold or are for sale.

In order to consolidate the ownership of the Prince George operations, the Company acquired the 25 per cent interest held by Feldmuehle A.G. in Intercontinental Pulp. This has enhanced the future strategic options for these mills and paved the way for a leaner management structure and other cost reduction measures.

Capital spending in 1985 totalled $59.5 million and focused on maintaining competitive and efficient manufacturing operations. Highly profitable internal opportunities as well as essential replacement and modernization projects were undertaken, including conversion of a Takla sawmill to stud production, upgrading of log handling in Grande Prairie and completion of the pulp machine project at Port Mellon. Also, several other major pulp mill projects were carried out to reduce costs, increase productivity, improve quality and conserve energy.

Following significant earlier productivity improvements, the Company's capital programs over the past two years, together with concerted efforts from all employees, have resulted in further gains. Output capacity per employee has increased by 17 per cent in wood products and by 21 per cent in pulp and paper. In building materials distribution, dollar sales per employee have increased by 19 per cent over the same two-year period.

The new 30 ton portal crane at Grande Prairie has improved log handling efficiency.

While achieving these gains in output, our employees have also improved on their already outstanding safety records and Canfor's 1985 performance on safety was second to none in the British Columbia forest industry.

Finally, significant measures have been implemented to reduce costs for energy, fibre, chemicals and transportation. The effect of these actions has been to achieve major economies which will contribute to an early restoration of profitability, even if the recovery of prices is only moderate.

Outlook and plans for 1986

The coming year is expected to be another strong one for home construction in the United States and in Canada as well, given a return of Canadian interest rates to lower levels. Although North American lumber prices will likely again be constrained by high production rates, firm demand should permit the Company's sawmills to operate at satisfactory rates, provided Canadian lumber producers are allowed to continue to compete fairly in the United States market.

Combined with relatively strong overall economic prospects, the positive housing outlook should allow Canfor's panelboard and building materials distribution businesses to achieve gains in 1986.

Wood products exports to offshore markets are expected to benefit from moderately improved demand and the strengthening of foreign currencies relative to the Canadian dollar.

The 1986 pulp market outlook is for continued steady demand in the major market areas, although worldwide capacity will still exceed demand. Pulp production curtailments will be required for maintenance and inventory control purposes at the Company's mills.

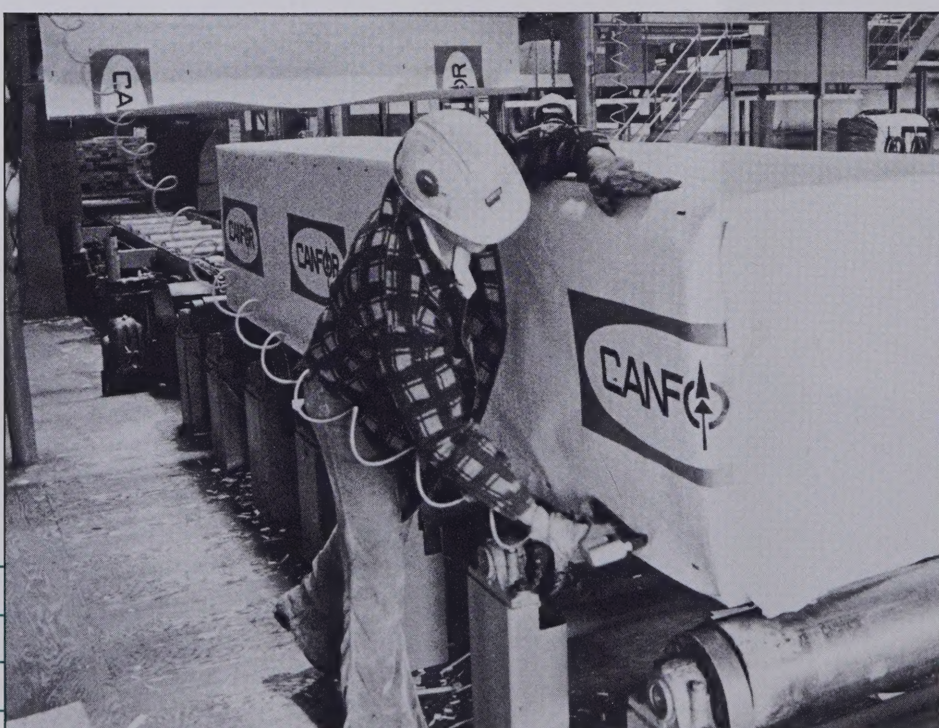
Improving international currency relationships and a decline in producers' pulp inventories around the world have contributed to a firming trend in prices. Together with the Company's more favorable cost structure, this should lead to a meaningful recovery from last year's severely depressed pulp results.

For sack kraft paper, it is expected that both demand and prices will improve modestly in 1986.

During the year, the collective agreements covering the Company's employees in British Columbia will be renegotiated, as will those of other forest companies in the province. Every effort will be made to ensure that these negotiations proceed on a timely and constructive basis and lead to agreements which are in the best interests of the Company's customers, employees, suppliers and shareholders.

Further development and implementation of the Company's strategic plan for debt reduction and profit recovery will also receive a high priority during 1986.

Based on the market outlook described above, as well as on the strategic actions which have been taken or are planned for the year, we are confident that Canfor will be profitable for 1986.



Paperwrap ensures lumber shipped by rail and truck arrives in clean condition.

Executive and board changes

In late February 1986, we were saddened by the loss of L.L.G. (Poldi) Bentley, a director and one of the founders of the Company, who passed away at age 80. His initiative, wise counsel and spirit of enterprise have been invaluable over the years.

During 1985, a number of senior employees retired or resigned after long and distinguished careers with Canfor. We are grateful for the dedicated service and valuable efforts of each of these individuals. In particular, we wish to acknowledge the contributions of J. Ron Longstaffe, who was a director and officer of the Company, and Robert R. Affleck, Glen A. Patterson and W. Michael Robson, who were officers. A number of other executive and board changes occurred during 1985 and Canfor's directors and officers are now as listed at the end of this annual report.

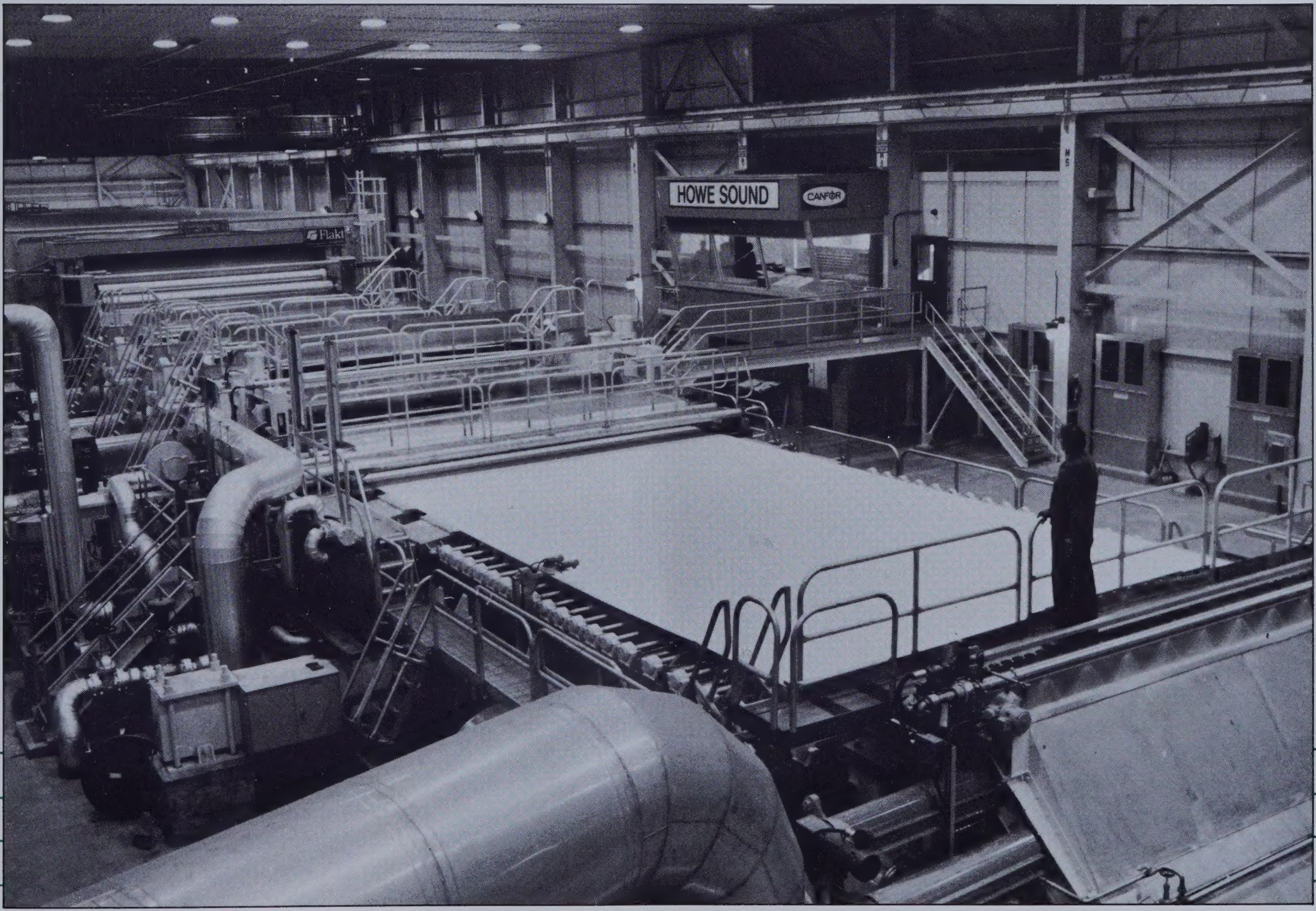
The new senior management team includes four corporate executives and a group of functional and operational vice-presidents or general managers. This smaller and more efficient senior organization is providing the co-ordination and flexibility required to meet the many challenges which Canfor faces in achieving an early return to profitability.

On behalf of the directors,

Peter J.G. Bentley
Chairman and Chief Executive Officer

March 14, 1986
Vancouver, British Columbia

The major modernization project at Howe Sound Pulp included the installation of a state-of-the art fourdrinier and an air float dryer.



Reforestation:

Canfor is proud of its record in forest management. The Company's reforestation program, in particular, is a model of success.

On lands where Canfor has the responsibility for reforestation, over 96 per cent of the logged area has been either completely reforested or is part of the current reforestation program.

The Company's reforestation program achieved two notable records in 1985. A total of 20,000 hectares of land was reforested, up 11 per cent from the previous year and the largest area ever done. Included in the program was the planting of 6.4 million seedlings, the highest number in Canfor's history.

In recent years, additional responsibility for reforestation has been transferred from the provincial governments to the industry. Canfor now has responsibility on 99 per cent of the lands it logs in British Columbia and 88 per cent in Alberta. In all cases, the cost of reforestation is ultimately borne by the Company either directly or through the payment of stumpage fees, timber royalties and forestland rentals.

Just 3.9 per cent of Canfor's logged area is classified as "backlog", that is, unsuccessfully reforested after a specified period of time. On the coast, where the Company has had responsibility for reforestation for over 20 years, the backlog is less than one per cent. Concentrated efforts in the interior and the northern forests will soon reduce the backlog in those regions to similar levels. Backlog areas are still very much a part of Canfor's reforestation program.

The backlog areas are mainly small sites within large, successful plantations. Many of these areas have been

A record 6.4 million seedlings were planted on Canfor forestlands in 1985.

our commitment to the future

reforested at least once and some may be partly restocked. Failures are often a result of poor soil conditions, drought, severe cold, insects, disease or weeds.

Even successfully established plantations can be overgrown by weeds. Since mechanical weed control is expensive and ineffective, herbicides are usually the preferred method. Despite comprehensive government safety regulations, however, limited public acceptance often restricts their use. Foresters must have reasonable access to herbicides if the weed control problem is to be satisfactorily resolved.

Reforestation efforts in British Columbia have also been frustrated by a chronic shortage of seedlings. To reforest all the province's backlog areas on a reasonable timetable, additional nursery capacity is required.

In 1985, the highly successful Balco Reforestation Centre, in which Canfor is a partner, grew 3.24 million seedlings, slightly more than one-half of the Company's requirements.

In addition to planting more trees, Canfor is developing better trees through its genetic improvement program. These trees will grow faster and yield greater volumes of higher quality wood than could normally be expected. In one phase, grafted stock from superior trees is being crossbred at seed orchards to produce seedlings having the same excellent characteristics as their parents. Another, more advanced phase of the program is a tissue culturing project in which clones of superior trees are being developed. Planting genetically improved seedlings can increase future crop yields by as much as 10 per cent.

While almost all sites on the coast are planted with seedlings, direct seeding and natural regeneration are used extensively in the interior and northern forests. For natural regeneration, sites are scarified to expose the mineral soil so that seed left by the logged trees can germinate and grow. Some areas are seeded directly, usually with a helicopter. The elimination of the time consuming and expensive nursery stage makes these techniques very cost effective.

As a young forest develops, there may be too many trees competing for the soil nutrients, light and water. Thinning the forest removes some trees to provide more growing space and promote better growth in the remainder. Thinning is sometimes combined with fertilizing to add 10 to 15 per cent to future crop yields.

In 1985, Canfor treated over 3800 hectares of land with intensive forest management techniques such as thinning, pruning and disease control.

Canfor's 44 professional foresters are ensuring that the Company's forest management program is at the forefront of the industry. By renewing the forests, Canfor is helping to ensure they will continue to provide employment and wealth for Canadians and wood products to serve the needs of people around the world.

PHOTOS

(TOP) At the Sechelt Seed Orchard, a forester pollinates seed cones in Canfor's genetic improvement program.

(CENTER) Clones of superior trees are being developed in a tissue culturing project initiated by Canfor.

(BOTTOM) The Balco Reforestation Centre, in which Canfor is a partner, can grow more than three million seedlings annually.

OPERATIONS REVIEW

Harvesting

In British Columbia, the year was one of the hottest and driest on record, resulting in a lengthy fire hazard season and the loss of some logging production time. Despite these restrictions, the total volume of wood harvested by all Canfor operations was up slightly from the previous year's level, to 6.9 million cubic metres.

On the coast, the harvest was down six per cent from the 1984 level. At Englewood, Vernon Camp was closed and the division's activities are now consolidated in Woss, thus reducing Company costs. The Harrison logging operation was down-sized to match long range annual timber supply and to increase economic efficiencies. The crew has been reduced to one-half its original size but, despite a 23 per cent reduction in the logging season resulting from fire hazard, production reached 63 per cent of the previous year's level.

In the northern interior of British Columbia, volume was up six per cent over the 1984 level. Takla Division sold its logging camps and reorganized its logging activities to reduce working capital and effect cost savings. Salvage logging began late in the year at the Chetwynd Division to recover wood damaged in the 7500 hectare Ran fire which burned for two months last summer. Of the record volume harvested by the Fort St. John Division, about one-third was acquired from private sales.

During the three month winter logging season in northern Alberta, crews work 24 hours a day to bring in the entire year's harvest while the frozen ground will support their equipment.

The volume of wood delivered in northern Alberta for the winter season was unchanged from the previous year's level. At Grande Prairie, mechanical delimbing of felled timber has resulted in greater efficiency in log handling.

Pulp and paper

Pulp production of 510,000 tonnes from the Company's three mills was well below capacity as the result of market curtailments taken in three of the four quarters of 1985. Pulp shipments of 530,000 tonnes, coupled with the curtailments, served to reduce inventories by close to 40 per cent between the first quarter peak and the year end. Although demand continued to be fairly strong, prices throughout the year remained at the disastrous levels they had reached after the late 1984 collapse. By year-end, however, producers' pulp inventories declined sharply and indications of firmer prices appeared.

Canfor's three mills operated well during 1985, with many new production records being set on a daily, weekly and monthly basis. Continued, strong emphasis on quality awareness and performance helped to maintain good customer acceptance for our pulp products. In September, the new pulp machine at Howe Sound Pulp began production after a trouble-free startup. The mill's newly-developed pulps, using different species mixes and offering specific characteristics, have been well received in the marketplace.

The pulps of Prince George Pulp and Paper and Intercontinental Pulp were also improved during the year by the installation and startup of new pulp cleaning and chip screening equipment. The mills can now offer their customers products which are essentially free of plastics and sclereids.

The outstanding safety performance of Prince George Pulp and Paper in 1985 was recognized with awards for the safest operation in Canfor, the safest pulp mill in British Columbia and safest pulp mill in Canada.

At all three mills, major cost savings were achieved during 1985 or developed for 1986, especially in the areas of wood supply, energy, chemicals and transportation. These savings were the result of earlier capital expenditures and the renegotiation of existing agreements. Cost savings were also brought about in many other supply and service areas through co-operative initiatives with suppliers.

Marketing was re-organized along product lines so that pulp and kraft paper sales staff are now divided into specialized teams for the two product lines worldwide. This division allows

Products from the new mill at Howe Sound Pulp have specific characteristics well received by papermakers worldwide.

greater attention to the separate products and better service to the customers.

As a result of curtailments, sack kraft paper production and sales of 89,000 tonnes were below capacity. Demand for this product, produced by Prince George Pulp and Paper, was depressed and prices continued to be unsatisfactory. The addition of an aqua steam shower to the paper machine further enhanced the quality of the paper by allowing full control over the moisture profile. Sack kraft manufacturing and transportation costs were also significantly reduced during the year.

Experience and a keen eye are essential in this final inspection of a reel of kraft paper.

Wood products

Lumber

Lumber production reached a record 1.3 billion board feet in 1985, a seven per cent increase over the previous year's level, while the sales volume was nine per cent higher.

Softwood lumber supply continued to exceed demand in all markets. In the key United States market, housing starts remained at the same healthy levels as 1984, exceeding 1.7 million units. However, as in 1984, strong competition and high production levels throughout North America kept prices depressed most of the year.

The price for random-length 2x4 Spruce/Pine/Fir fluctuated from a low of U.S.$128 per thousand board feet in March to a high of $173 in May, but for most of the year remained at the $150 to $155 level.

Overseas markets provided little relief, as the high value of the American and Canadian dollars against foreign currencies hurt the competitiveness of North American producers until the latter part of the year when the currency relationship improved.

Despite the oversupplied markets and inadequate prices, Canfor lumber mills were able to maintain normal operating levels, as the result of improved efficiency and productivity combined with innovative marketing activities.

Producers in the United States are again seeking to have some restriction placed on Canadian lumber imports. The Canadian industry continues to lobby against the imposition of any trade barriers.

In 1985, Canfor lumber mills placed greater emphasis on developing value-added and specialty products to improve mill returns and reduce reliance on oversupplied commodity lumber markets.

Each of these highly efficient centerbeam railcars carries up to 95,000 board feet of lumber.

For example, Takla's Fort St. James mill marketed select structural grades of 2x10 and 2x12 SPF, mostly to Japanese buyers, at premium prices. Grande Prairie Lumber's new finger-jointing test plant came on line in 1985, and its production of fingerjointed studs was well received in the marketplace.

About 45 per cent of Eburne's production was marketed in Japan, including kiln dried hemlock dimension lumber which sold at substantial premiums. The mill increased production of clear flitches which also sell at premium prices. Non-company mills were contracted to custom cut a portion of Canfor's yellow cedar, and to remanufacture some of Eburne's hemlock lumber to achieve higher returns and improve the Company's market position in Japan.

Value-added products were also featured at Terminal Sawmills, an independent cedar mill in Vancouver. Canfor supplies logs to Terminal and markets its production. In 1985, Terminal began producing end matched panelling and fingerjointed panelling and siding, both high value-added items. The mill's 1985 sales of 66 million board feet were 20 per cent higher than the previous year's level.

Several Canfor mills set production records during the year, notably Takla Division's Fort St. James operation and Alberta Operations' High Level Division, but overall the emphasis was on improving efficiency and lumber recovery. Fort St. John Division made

New facilities at Eburne produce these clear flitches which sell at premium prices.

sizable improvements in both lumber yield and machine availability through better maintenance while new equipment increased lumber recovery at High Level and Hines Creek, as well. Grande Prairie's new $3.5 million 30 ton portal crane went into operation in January 1986 and is expected to significantly reduce log yard operating costs and log breakage.

Sales to major retail accounts and regional buying groups were increased substantially. In recognition of its marketing efforts, the Company has been nominated as one of the five finalists in a prestigious American competition to name the top building materials marketing organization of the year.

The Company successfully met the challenge presented by the deregulation of the American rail system. Also, reductions in rail rates to some areas benefited the Company's interior British Columbia and Alberta mills.

Plywood

Increased construction in Canada resulted in improved markets for plywoods, especially sheathing grades for which mill net returns showed a substantial improvement over the previous year's level.

After a thorough study of markets for sanded fir products, the unprofitable plywood plant in New Westminster was permanently closed in October. The Company's other remaining plywood facilities continued to produce sheathing grade panels at profitable levels. Total volume for the year was down slightly from the previous year due to the closure.

Hardboard

Canfor is the leading hardboard distributor in Canada and last year further gains were achieved in the much larger United States market where additional sales agents have been appointed.

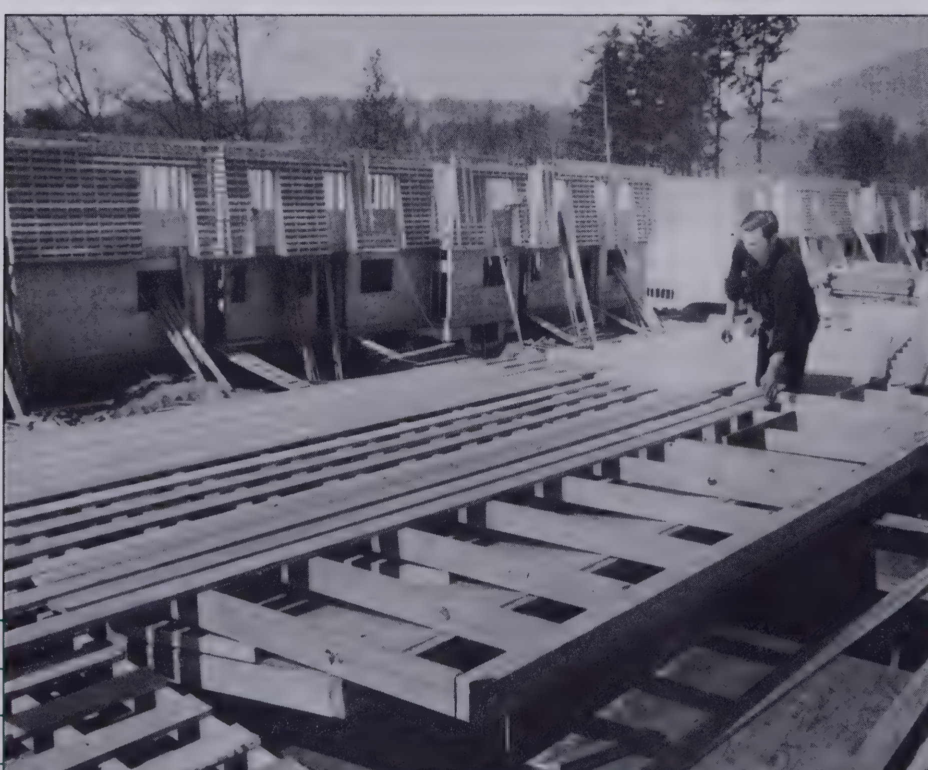
Sales of hardboard products were up by 28 per cent compared to 1984 levels but volumes in the more profitable prefinished speciality lines were static, and mill net returns were lower as a result of a higher proportion of brownboard sales. Product lines were further rationalized during the year to concentrate on the better selling panels and new marketing strategies have been implemented to develop a more profitable product mix for the plant.

Shingles

Oversupply in the primary United States market eased slightly compared with previous years, but prices remained depressed.

Huntting-Merritt, the Company's only shingle mill, produced 117,000 squares of shingles, up 14 per cent from 1984, despite crew reductions of 13 per cent. This mill remained the safest in the industry for the sixth year in a row and continued to enjoy market recognition for its high quality products, which sell at substantial premiums.

Early in 1986, the United States' International Trade Commission found that American producers had suffered an injury as the result of imports of Canadian shingles and shakes. Although shingles are a relatively small product line, Canfor will continue to monitor this situation and lend its support to the industry to combat any restrictions.



The number of housing starts in the primary United States market remained at 1.7 million.

Building materials distribution

In Canada, the Building Materials Division completed a major restructuring in 1985 and achieved a sales increase of 5.5 per cent to a record $322 million. Expenses were cut by nine per cent, profitability was increased, and capital employed relative to sales was reduced.

One factor in this improvement was a more active Canadian construction sector. Housing starts exceeded 165,000, a 23 per cent increase over the 1984 level and the highest since 1981.

Another factor was BMD's downsizing, which was largely completed during the first quarter. The number of distribution centres was reduced from 28 to 21, and these were grouped into three regional organizations, down from five. Staffing was reduced by 18 per cent from mid-1984 levels.

Service to the market areas of closed distribution centres has been maintained using resident sales representatives and truck delivery, with significantly improved overall efficiency. For example, inventory utilization increased by more than 25 per cent and turnover reached a record level.

BMD's 1985 sales improvement was led by lumber, which in only a few years has become its largest selling product. Record lumber sales in 1985 included especially strong gains by western species.

Markets were particularly good in Ontario and Quebec, and BMD's Central Region capitalized on the opportunity, leading the division and setting records in both sales and profits. During the year, the Toronto Distribution Centre was expanded and improved.

In Nova Scotia, the Halifax warehouse and Atlantic Region headquarters moved to a new, larger facility in nearby Dartmouth.

The Company's American distribution organization, Canfor U.S.A. Corporation, had an unsuccessful year but substantial changes are being made to improve its profitability.

Mill returns on sheathing grades of plywood improved substantially in 1985.

FINANCIAL REVIEW

Management responsibility

The information and representations in this annual report were prepared by Canfor's management, and reviewed and approved by the directors. The consolidated financial statements were prepared in conformity with accounting principles generally accepted in Canada and, where necessary, reflect management's best estimates and judgements. The financial information presented throughout this report is consistent with that presented in the consolidated financial statements.

Operating results

Operating results for 1985 showed a $36.9 million reversal from the improvements made in 1984. This reversal was wholely attributable to the pulp and paper segment which suffered a $35.2 million operating loss in 1985, compared with a $14.6 million operating profit in 1984. This was caused by a severe plunge in pulp sales prices coupled with the costs of curtailing production to maintain acceptable inventory levels.

Improvements in the wood and wood products segment and the building materials segment provided some offset to the unfavorable results in pulp and paper. Wood and wood products sales increased by $23.7 million to $287.8 million owing to higher sales volumes and improved prices from 1984 levels. As a consequence of these increased sales and reduced costs through higher productivity, operating profit increased by $12.5 million to $21.0 million in 1985.

Despite the closure of seven Canadian distribution centres in early 1985, building materials sales increased by $38.3 million over 1984 and operating profit increased from $1.4 million in 1984 to $3.2 million in 1985.

While borrowing levels were higher during 1985, interest expense was reduced by $5.0 million, reflecting the lower interest rates prevailing during the year.

The laboratory is a vital part of the quality program at Canfor's pulp and paper mills.

Changes in financial position

Cash generation from operating activities was reduced by $30.5 million to $0.8 million in 1985 as a result of the operating loss in the pulp and paper segment.

During 1985, $50.7 million was generated through the sale of Canfor's investment in Yorkshire Trust and the major portion of its investment in Versatile Corporation, as well as the sale of properties surplus to its needs. These funds were applied to offset bank borrowings and to finance a portion of the capital program and debt retirement during the year.

Canfor's 1985 capital program, including capitalized interest, amounted to $59.5 million, which was $18.5 million greater than in 1984. A substantial portion of the 1985 capital program related to the completion in August 1985 of the pulp machine at the Howe Sound Pulp Division. The remainder of the capital program continued to be restricted to essential and high return projects.

During the year, Canfor purchased working interests in certain oil and gas properties, referred to in the petroleum industry as 'carve out' agreements. The Company realized $9.8 million in cash during 1985 and expects to realize a further $29 million before these agreements expire in 1986.

Income taxes

Canfor has investment tax credits amounting to $21.1 million available to reduce future income taxes payable. It also has losses of $168.4 million in its

Canadian operations and $36.3 million in its United States operations available to reduce future taxable income. In addition, $76.2 million of depreciation may be claimed for tax purposes to reduce future taxable income.

The potential income tax benefits associated with $15.7 million of the investment tax credits and $75.3 million of the above losses have not been reflected in Canfor's accounts as a result of its policy of not recognizing such items until they are realized or are virtually certain of being realized.

Financial position

During 1985, Canfor continued to work towards strengthening its financial position through such actions as the streamlining of its building materials operations, closure of its unprofitable plywood mill at New Westminster, British Columbia and the previously mentioned sale of investments and surplus property. In March 1986, negotiations were concluded for the sale of Canfor's 50.38 per cent interest in Balco Industries Ltd. for net proceeds of $10.2 million.

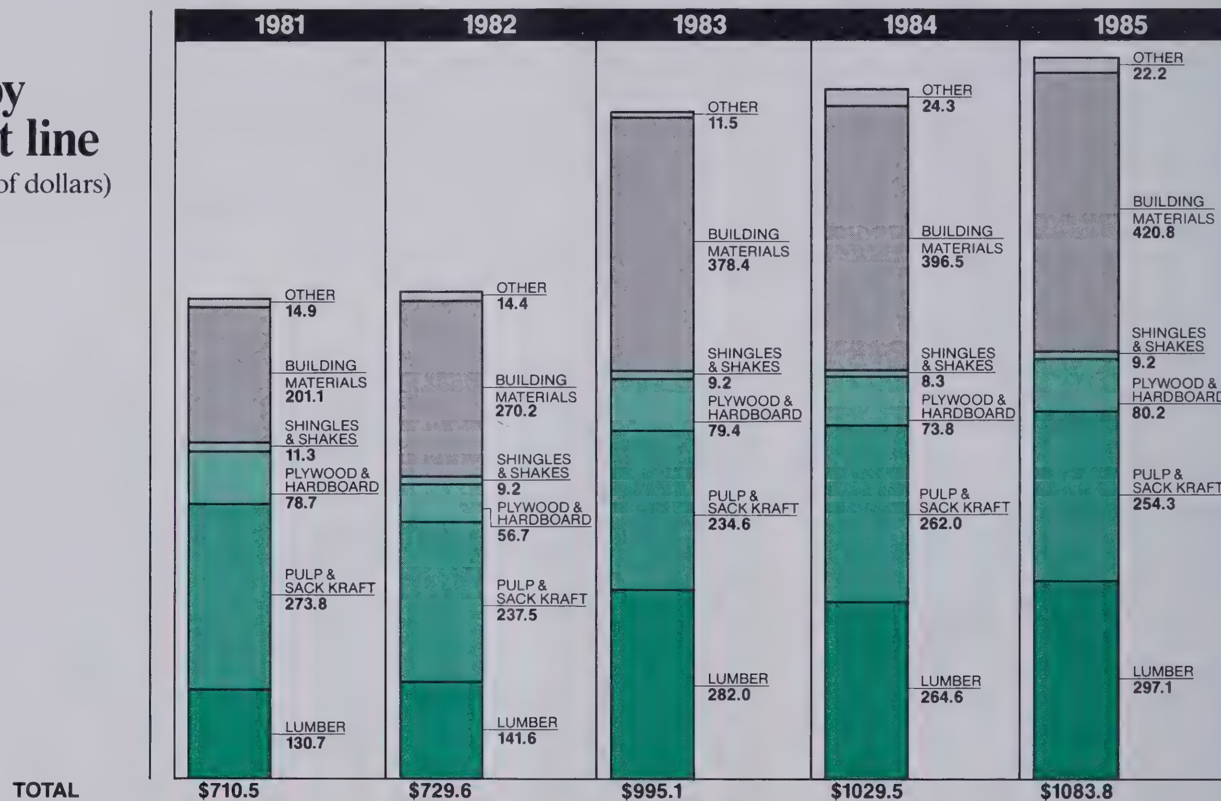
During the past several years of difficulty for the forest products industry, Canfor has maintained capital spending at levels which it considered appropriate for increasing productivity, improving quality and reducing costs, so as to benefit quickly from an upswing in the market cycle for its products. This will allow Canfor's capital expenditure program for 1986 to be considerably reduced although it will still contain significant amounts for high return projects. This will also permit a substantial proportion of the cash generated from operations in 1986 to be available for debt reduction without impairing future profitability.

In addition, the benefits of the capital projects and management restructuring implemented in 1984 and 1985 have positioned Canfor to strengthen its financial position substantially in 1986. The anticipated financial improvement will be enhanced if the current positive trends in pulp and lumber markets continue.

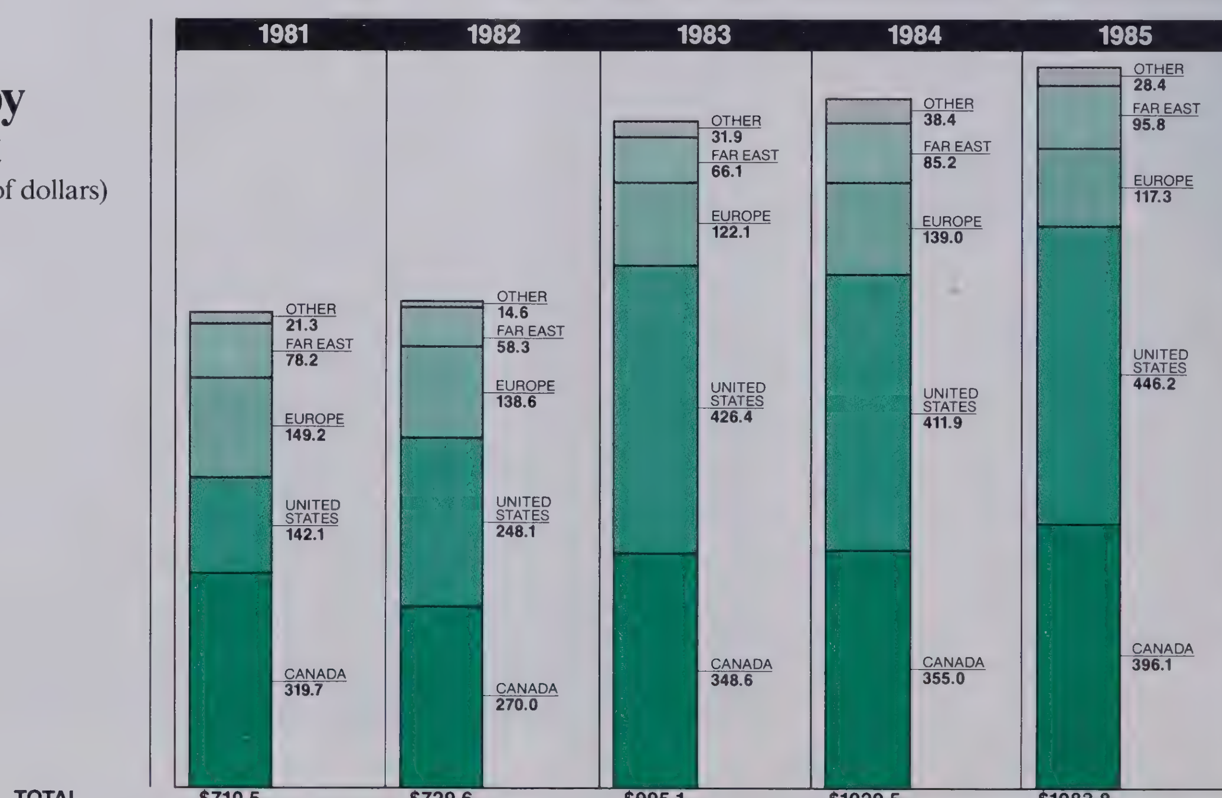
A log inspector examines a boom of logs in the Fraser River near Vancouver.

Sales information

Sales by product line
(in millions of dollars)



Sales by market
(in millions of dollars)



Summary of principal accounting policies

December 31, 1985

Basis of presentation of financial statements

These financial statements include the accounts of Canfor Corporation (the Company) and its subsidiary companies (Page 26), hereinafter referred to as "Canfor".

Canfor's investment in B.C. Chemicals Ltd., an affiliated company, is accounted for on the equity basis.

Valuation of inventories

Inventories of wood products, pulp, sack kraft paper, building materials, logs and chips are valued at the lower of average cost and net realizable value. Processing materials and supplies are valued at the lower of average cost and replacement cost.

Property, plant and equipment

Canfor capitalizes the costs of major replacements, extensions and improvements to plant and equipment, together with related interest expense incurred during the construction period.

Depreciation of logging and manufacturing assets is calculated on a unit of production basis.

Depreciation of plant and equipment not employed in logging and manufacturing is based on the estimated useful lives of the assets and is calculated on a straight-line basis.

Amortization of logging roads is dependent upon their nature and is calculated on either a straight-line basis or on the basis of the volume of timber removed.

Depletion of timber is calculated on the basis of the volume of timber removed.

Deferred charges

Deferred financial costs are amortized over the lives of the related debt. Software development costs, relating to major systems, are deferred and amortized over periods not longer than ten years.

Pension costs

Canfor has various contributory and non-contributory pension plans which cover most salaried employees and certain hourly employees not covered by forest industry-union pension plans.

Current service pension costs are charged to earnings as they accrue. Past service costs resulting from plan improvements are charged to earnings and funded at rates which, based on independent actuarial estimates, will provide for the obligation over periods not longer than fifteen years. Pension agreements with certain executives (some of whom are retired) who are not participants in Canfor's pension plans are not funded. Annual costs under these agreements are charged to earnings and the liabilities are included in other long-term liabilities.

Foreign currency translation

Foreign currencies are translated into Canadian dollars using the temporal method as follows:

Monetary assets and liabilities at year-end or applicable hedged exchange rates; non-monetary assets and liabilities at historical rates; revenues and expenses at exchange rates prevailing at the time the transaction occurs.

Exchange gains or losses are reflected in income immediately with the exception of unrealized translation gains or losses related to long-term monetary liabilities hedged by future revenue streams, which are deferred until realized.

Canfor's foreign operations are considered to be self-sustaining and the assets and liabilities are translated using the current rate method. The translation gain or loss is included as a component of shareholders' equity.

Income taxes

Canfor accounts for income taxes on the tax allocation method. Under this method, timing differences between reported and taxable income result in provisions for taxes not currently payable. Such timing differences arise principally as a result of claiming depreciation, depletion, amortization and deferred charges for tax purposes at amounts differing from those charged to income.

Investment tax credits are accounted for by using the cost reduction method.

Consolidated statement of income and earnings reinvested in the business

(in thousands of dollars)

	Year ended December 31	
	1985	1984 *(Note 19)*
Net sales	**$1,083,799**	$1,029,532
Costs and expenses		
Cost of products sold	**997,101**	908,421
Depreciation, depletion and amortization	**45,277**	45,071
Selling and administration	**64,986**	62,693
	1,107,364	1,016,185
Operating (loss) income	**(23,565)**	13,347
Interest expense *(Note 12)*	**(39,260)**	(44,244)
Other income	**3,730**	2,897
Oil and gas income *(Note 11)*	**25,760**	-
Loss before income taxes	**(33,335)**	(28,000)
Income tax (expense) recovery *(Note 16)*		
Current	**825**	1,844
Deferred	**(21,556)**	1,204
	(20,731)	3,048
Loss before undernoted items	**(54,066)**	(24,952)
Equity in income (loss) of affiliated companies	**(8,183)**	1,355
Minority interests in subsidiaries	**(282)**	2,343
Loss before extraordinary items	**(62,531)**	(21,254)
Extraordinary items *(Note 14)*	**1,077**	(2,610)
Net loss	**$ (61,454)**	$ (23,864)
Net loss per common share (after provision for dividends on preferred shares)		
Before extraordinary items	**$ (3.73)**	$ (1.31)
After extraordinary items	**$ (3.67)**	$ (1.45)
Earnings reinvested in the business at beginning of year *(Note 21)*		
As previously reported	**$ 82,546**	$ 113,584
Foreign exchange adjustment *(Note 1)*	**5,622**	4,229
As restated	**88,168**	117,813
Net loss for the year	**(61,454)**	(23,864)
Preferred share dividends	**(6,730)**	(3,253)
Share issue expense	**-**	(2,528)
Earnings reinvested in the business at end of year	**$ 19,984**	$ 88,168

Consolidated cash flow statement

(in thousands of dollars) *Year ended December 31*

	1985	1984 (Note 19)
Cash generated from (used in)		
Operating activities		
Operating (loss) income	$ (23,565)	$ 13,347
Depreciation, depletion and amortization	45,277	45,071
Proceeds on disposal of assets	5,051	2,315
Gain on disposal of assets	(1,483)	(545)
Working capital changes	10,127	11,873
Income tax recovery	825	1,844
Other	3,795	1,676
	40,027	75,581
Interest (net of capital portion)	(39,260)	(44,244)
	767	31,337
Financing activities		
Long-term liabilities	(43,196)	(14,201)
Dividends by		
Canfor to preferred shareholders	(6,730)	(3,253)
Subsidiary to minority interests	(52)	-
Common shares	-	16
Preferred shares	-	75,000
Share issue expense	-	(2,528)
	(49,978)	55,034
Investing activities		
Property, plant and equipment	(59,500)	(41,045)
Dividends from affiliated companies	56	1,063
Extraordinary items *(Note 14)*	50,651	(2,610)
Oil and gas *(Note 11)*	9,832	-
Other	(5,307)	(2,080)
	(4,268)	(44,672)
(Increase) decrease in net short-term indebtedness*	(53,479)	41,699
Short-term indebtedness at beginning of year	(137,500)	(179,199)
Short-term indebtedness at end of year	$(190,979)	$(137,500)
Operating working capital changes		
Accounts receivable	$ (1,395)	$ 8,794
Inventories	25,401	(20,564)
Income taxes	(790)	340
Accounts payable	(13,089)	23,303
	$ 10,127	$ 11,873

* *Net short-term indebtedness consists of cash, temporary investments, unpresented cheques and bank loans.*

Consolidated balance sheet

(in thousands of dollars)

	December 31 1985	1984 *(Note 19)*
ASSETS		
Current assets		
Cash and temporary investments *(Note 9)*	**$ 41,849**	$ 5,050
Accounts receivable		
Trade	**105,210**	104,696
Other	**29,621**	12,285
Affiliated companies	**561**	266
Income taxes recoverable	**1,136**	346
Inventories *(Note 2)*	**198,768**	224,282
Oil and gas investment *(Note 11)*	**19,369**	-
Total current assets	**396,514**	346,925
Long-term investments		
Affiliated companies, at equity *(Note 3)*	**3,191**	65,597
Deposits and other investments, at cost *(Note 3)*	**19,354**	7,514
	22,545	73,111
Property, plant and equipment *(Note 4)*	**443,794**	435,872
Timber *(Note 4)*	**10,802**	12,861
Other assets *(Note 5)*	**7,145**	4,045
Deferred charges *(Note 6)*	**33,958**	26,783
	$914,758	$899,597

Auditors' report

To the Shareholders of Canfor Corporation:

We have examined the consolidated balance sheet of Canfor Corporation as at December 31, 1985 and the consolidated statements of income and earnings reinvested in the business and cash flow for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Company as at December 31, 1985 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles which, except for the change in the method of accounting for investment tax credits as explained in Note 1, have been applied on a basis consistent with that of the preceding year.

Price Waterhouse

Chartered Accountants

February 17, 1986
(March 4, 1986 as to Note 20)

December 31	1985	1984 (Note 19)
LIABILITIES		
Current liabilities		
Bank loans and unpresented cheques *(Note 7)*	**$232,828**	$142,550
Accounts payable and accrued liabilities *(Note 18)*	**136,717**	126,284
Accounts payable to affiliated companies	**-**	68
Current portion of long-term debt *(Note 8)*	**24,815**	28,360
Dividends payable	**876**	1,210
Total current liabilities	**395,236**	298,472
Long-term liabilities		
Long-term debt *(Note 8)*	**187,851**	220,385
Other liabilities	**10,948**	10,608
	198,799	230,993
Deferred income taxes	**20,473**	618
Minority interests in subsidiaries	**8,272**	9,801
	622,780	539,884
SHAREHOLDERS' EQUITY		
Share capital *(Note 9)*		
Preferred shares	**86,000**	86,000
Common shares	**185,386**	185,386
	271,386	271,386
Foreign exchange translation adjustment	**608**	159
Earnings reinvested in the business *(Note 21)*	**19,984**	88,168
	291,978	359,713
Commitments and contingent liabilities *(Note 15)*		
Subsequent event *(Note 20)*		
	$914,758	$899,597

APPROVED BY THE BOARD

Peter J.G. Bentley, Director

Ronald L. Cliff, Director

Notes to consolidated financial statements
December 31, 1985

1. Accounting policies
The principal accounting policies followed by Canfor are summarized under the caption "Summary of principal accounting policies".

Canfor has reassessed its foreign exchange exposure and believes that its U.S. dollar sales provide an effective hedge against the U.S. dollar debt. Foreign exchange gains and losses on translation of U.S. dollar loans, which were formerly deferred and amortized over the life of the related debt, are deferred and charged to income when realized. As a result of this adjustment, which has been made retroactively, the net loss has been decreased by $518,000 ($.03 per share) in 1985 (1984 - $1,393,000) ($.08 per share).

Commencing in 1985, Canfor changed its method of accounting for investment tax credits from the flow through method to the cost reduction method. This change had no material impact on earnings.

2. Inventories

	1985	1984
	($000's)	
Wood products, pulp, sack kraft paper and building materials	**$119,243**	$143,195
Logs and chips	**52,163**	54,205
Processing materials and supplies	**27,362**	26,882
	$198,768	$224,282

3. Affiliated companies, at equity
Shares at cost plus equity in undistributed net income since acquisition

	1985	1984	**1985**	1984
	% Ownership		($000's)	
Versatile Corporation	**—**	39.07	**$ —**	$52,513
Yorkshire Trust Company	**—**	45.89	**—**	10,324
B.C. Chemicals Ltd.	**50.00**	50.00	**3,191**	2,760
			$3,191	$65,597

During 1985, Canfor sold part of its investment in Versatile Corporation, retaining a ten percent interest which is held by a subsidiary company. The remaining investment, which is reserved against the exchangable preferred shares, is carried at a cost of $11,702,000 (market value — $11,385,000) and is included in deposits and other investments as at December 31, 1985. During the year, Canfor also sold its investment in Yorkshire Trust Company.

4. Property, plant and equipment and timber
Property, plant and equipment

	Cost	Accumulated Depreciation	Net book value
		($000's)	
December 31, 1985			
Land	**$ 14,864**	**$ —**	**$ 14,864**
Pulp and paper mills	**466,807**	**191,490**	**275,317**
Sawmills, plywood, hardboard, shake and shingle mills	**238,633**	**141,974**	**96,659**
Logging buildings and equipment	**46,097**	**34,636**	**11,461**
Logging roads and bridges	**64,033**	**47,335**	**16,698**
Other equipment and facilities	**60,509**	**31,714**	**28,795**
	$890,943	**$447,149**	**$443,794**
December 31, 1984			
Land	$ 15,960	$ —	$ 15,960
Pulp and paper mills	435,618	175,670	259,948
Sawmills, plywood, hardboard, shake and shingle mills	252,069	145,420	106,649
Logging buildings and equipment	51,566	37,539	14,027
Logging roads and bridges	58,007	44,397	13,610
Other equipment and facilities	47,487	21,809	25,678
	$860,707	$424,835	$435,872

Timber

	Cost	Accumulated Depletion	Net book value
		($000's)	
December 31, 1985	**$ 27,217**	**$ 16,415**	**$ 10,802**
December 31, 1984	$ 28,264	$ 15,403	$ 12,861

5. Other assets

	1985	1984
	($000's)	
Contract receivable	**$ 3,006**	$ 3,021
Future income taxes recoverable	**3,979**	862
Advances receivable — affiliated company	**160**	162
	$ 7,145	$ 4,045

6. Deferred charges

	1985	1984
	($000's)	
Unrealized foreign exchange losses on long-term debt	**$ 26,884**	$ 19,427
Software development costs	**6,195**	6,826
Debt issue and other expense	**879**	530
	$ 33,958	$ 26,783

7. Bank loans and unpresented cheques

Operating bank loans of $232,828,000 (1984 - $142,550,000), including unpresented cheques of $12,893,000 (1984 - $16,096,000) are, with the exception of a $23,887,000 loan, secured by a general assignment of accounts receivable and hypothecation of inventories. In addition, $191,048,000 is secured by a floating charge on all the assets of Intercontinental Pulp Company Ltd. The lines of credit arranged under the terms of the loans were $244,788,000 (1984 - $278,440,000).

8. Long-term debt

	1985	1984
	($000's)	
CANFOR CORPORATION		
The Prudential Insurance Company of America, $39,600,000 U.S. note payable, interest at 8.875%, repayable in instalments in the years 1986 - 1998	**$ 55,499**	$ 55,963
Chemical Bank, $5,000,000 U.S. note payable, interest at 9.4%, repayable in the year 1986	**7,008**	13,230
Chemical Bank, $8,000,000 U.S. loan agreement, interest at U.S. prime	**—**	10,584
$50,000,000 U.S. note agreement with a Canadian bank, interest at a rate related to the U.S. dollar London Interbank rate for U.S. dollar deposits (LIBOR) ranging to a maximum of LIBOR plus ⅞%, repayable in instalments in the years 1988 - 1992	**70,075**	66,150
	132,582	145,927
PRINCE GEORGE PULP AND PAPER LIMITED		
First mortgage sinking fund bonds, maturing January 15, 1985		
U.S.$ Series A, interest at 5⅝%	**—**	2,352
Series B, interest at 6⅛%	**—**	1,782
Term loan agreement in U.S. dollars, with two Canadian banks, interest at a rate related to LIBOR ranging to a maximum of LIBOR plus 1%, repayable in instalments in the years 1986 - 1992 ($43,750,000 U.S.)	**61,293**	65,109
	61,293	69,243
INTERCONTINENTAL PULP COMPANY LTD.		
First mortgage sinking fund bonds		
U.S.$ Series A, interest at 5¾%	**—**	6,413
Series B, interest at 6⅞%	**—**	1,800
Series A subordinated debentures	**—**	3,000
	—	11,213
BALCO INDUSTRIES LTD.		
Promissory note plus 7% accrued interest, repayable in instalments in the years 1986 - 1987, accrued interest payable in 1988	**4,212**	4,872
Bank loan, interest at Canadian bank prime plus 1%, repayable in instalments in the years 1986 - 1987	**1,700**	4,500
	5,912	9,372
TAKLA FOREST PRODUCTS		
Bank loan, interest at Takla's option of Canadian bank prime plus ½% or prevailing LIBOR plus 1% or prevailing Bankers' Acceptance rate plus 1¼%, repayable in instalments in the years 1986 - 1987	**2,400**	3,900
WESTCOAST CELLUFIBRE INDUSTRIES LTD.		
Bank loan, interest at Canadian bank prime plus ½%, repayable in instalments in the years 1986 - 1987	**2,000**	2,500
CANFOR U.S.A. CORPORATION		
$3,681,608 U.S., interest at U.S. bank prime plus ¼%, repayable in instalments in the years 1986 - 1990	**5,158**	4,869
Other notes payable and capital leases, repayable in the years 1986 - 1990	**3,321**	1,721
	212,666	248,745
Less: Current portion	**24,815**	28,360
	$187,851	$220,385

The bank loans are secured by general assignments of accounts receivable and hypothecation of inventories. In addition, $74,475,000 is secured by a floating charge over all the assets of Intercontinental Pulp Company Ltd.

The agreements relative to The Prudential Insurance Company of America and Chemical Bank notes and the note agreement contain provisions limiting the amount of indebtedness which the Company and designated subsidiaries can incur and limiting the amount of cash dividends on common shares to $43,438,000 at December 31, 1985.

The term loan agreement includes a provision for unsecured loans to a maximum equivalent of U.S. $43,750,000.

Repayments on long-term debt required in each of the next five years are as follows

	($000's)
1986	$24,815
1987	$18,032
1988	$30,732
1989	$28,137
1990	$27,845

9. Share capital

	1985	1984
	($000's)	
CANFOR CORPORATION		
Authorized		
110,000 7% cumulative, redeemable non-voting preferred shares, with a par value of $100 each		
10,000,000 Class A non-voting preferred shares with a par value of $25 each, of which		
1,000,000 of such Class A preferred shares are designated $2.25 cumulative redeemable exchangeable Class A preferred shares, Series 1		
2,000,000 of such Class A preferred shares are designated floating rate cumulative redeemable retractable Class A preferred shares, Series 2		
50,000,000 common shares without par value		
Issued		
110,000 7% preferred shares	**$ 11,000**	$ 11,000
1,000,000 Class A preferred shares, Series 1	**25,000**	25,000
2,000,000 Class A preferred shares, Series 2	**50,000**	50,000
18,575,475 common shares	**185,386**	185,386
	271,386	271,386
Preferred shares issued to subsidiary company	**(50,000)**	(50,000)
CANFOR CAPITAL LIMITED		
Issued		
2,000,000 senior preferred shares, Series 1	**50,000**	50,000
	$271,386	$271,386

7% PREFERRED SHARES
The 7% preferred shares rank on a parity with the Class A preferred shares and are entitled to preference over the common shares with respect to the payment of cumulative dividends at the rate of 7% per annum. So long as any 7% preferred shares are outstanding the Company may not, without the approval of the holder of the 7% preferred shares given by special resolution, redeem or purchase any common shares.

CLASS A PREFERRED SHARES
The Class A preferred shares rank on a parity with the 7% preferred shares and are entitled to preference over the common shares with respect to the payment of dividends.

EXCHANGEABLE CLASS A PREFERRED SHARES
The exchangeable preferred shares entitle the holders at any time prior to the close of business on June 30, 1991 or the third business day prior to the date fixed for redemption, whichever is earlier, to acquire from Canfor 2.778 Class A subordinate voting shares of Versatile Corporation, which is equivalent to an exchange price of $9.00 per Class A subordinate voting share.

On and after July 1, 1987 and prior to July 1, 1989, the exchangeable preferred shares are redeemable at $26.00 per share if the Class A subordinate voting shares of Versatile Corporation have traded on a designated stock exchange for a specified period at a weighted average price of not less than 125% of the exchange price. On and after July 1, 1989, the exchangeable preferred shares are redeemable at $26.00 per share declining by $0.25 annually to $25.00 on and after July 1, 1993, in each case plus accrued and unpaid dividends.

During each calendar quarter and commencing in the first full calendar quarter following the expiry of the exchange privilege, the Company will make all reasonable efforts to purchase for cancellation, at a price not exceeding $25.00 per share plus costs of purchase, 1% of the number of exchangeable preferred shares outstanding on the expiry of the exchange privilege. This obligation is cumulative within each calendar year.

The exchangeable preferred shares carry a right to cumulative preferred cash dividends at a rate of $2.25 per share per annum.

RETRACTABLE CLASS A PREFERRED SHARES
In 1984, the Company issued 2,000,000 floating rate cumulative redeemable retractable Class A preferred shares, Series 2, at a price of $25.00 per share, to a wholly-owned subsidiary, Canfor Capital Limited. Concurrently, Canfor Capital Limited made a public issue of 2,000,000 floating rate senior preferred shares at a price of $25.00 per share. The proceeds of this issue were used to purchase the floating rate preferred shares of Canfor Corporation.

In conjunction with the Canfor Capital Limited issue, a support agreement was entered into among Canfor Capital Limited, Canfor Investments Ltd., a Canadian chartered bank, and The Royal Trust Company in which the bank unconditionally covenants to ensure that all obligations of Canfor Capital Limited to holders of the floating rate preferred shares are met under conditions in which redemption is required. The commitment of the bank will expire on November 30, 1991 if all dividends, retraction and redemption obligations to that date have been met.

Also, a standby credit agreement was entered into among Canfor Capital Limited, Canfor Investments Ltd., and a Canadian chartered bank, with respect to the repayment, on demand, of any funds loaned by the bank under the support agreement. Cash in the amount of $40.5 million received from the sale of the Versatile and Yorkshire shares is held in a cash collateral account and replaces these shares which were originally pledged under the agreement. The Company intends to provide alternative security during 1986.

COMMON SHARES
The holders of the common shares have no pre-emptive, redemption or conversion rights.

10. Senior management stock option plan

The Company has established a Senior Management Stock Option Plan for officers and certain employees of Canfor. The Company has reserved 500,000 common shares for issue under this plan and has granted in 1985, options covering 155,650 of these shares for which the exercise price is $9.00 per share; and in 1983, options covering 304,350 of these shares for which the exercise price is $21.75 per share. No options were exercised in 1985 (1984 - 700 shares).

11. Oil and gas

(a) On May 22 and 23, 1985, Canadian Forest Products Ltd. entered into agreements to purchase working interests in certain oil and gas properties, and in return granted to the seller, irrevocable options to repurchase the working interests at any time after payout, but before July 31, 1986.

On June 13, 1985, Canadian Forest Products Ltd. entered into an agreement with a Canadian bank to finance the purchase of these oil and gas properties. As at December 31, 1985, this loan was repaid.

(b) On June 28, 1985, Canfor Limited and Canfor Properties Ltd. entered into an agreement to purchase working interests in certain oil and gas properties which are secured by a fixed and specific charge, in consideration for 150,000 fully paid preferred shares of $100 per share.

This agreement offers the seller the right to repurchase the working interests at any time before December 29, 1986.

The 1985 results from these agreements are as follows

	($000's)
Income from oil and gas activities	$25,760
Depletion	63,831
Working capital changes	3,441
	93,032
Debt repayments	83,200
Cash flow from oil and gas	$ 9,832

12. Interest expense

Interest expense is net of interest income and capitalized interest. Long-term and short-term interest expense amounted to $20,730,000 (1984 - $25,516,000) and $18,530,000 (1984 - $18,728,000) respectively.

13. Unfunded pension and retirement accruals

Canadian Forest Products Ltd. has pension agreements with certain executives, the liability for which is accrued but not funded. The total accrued liability based on an actuarial valuation during 1985 is $6,224,000 (1984 - $6,492,000).

Canadian Forest Products Ltd. and Canfor Limited also have unfunded accrued liabilities of $944,000 in respect of retirement allowances at December 31, 1985 (1984 - $711,000).

Canfor's other pension plans are funded. Based on actuarial valuations conducted during 1983 and 1984, there was an estimated net accrued surplus of $5,439,000 at December 31, 1985 (1984 - $7,516,000). Accrued surpluses were used to fund the companies' current service costs, which for 1985 amounted to $3,166,000 (1984 - $3,022,000).

14. Extraordinary items

	Gain (loss)		Cash from (used in)	
	1985	1984	**1985**	1984
	($000's)		($000's)	
Sale of land and warehouses (net of tax of $1,276,000)	**$ 3,681**	$ -	**$ 7,871**	$ -
Sale of long term investments (net of tax of $318,000)	**1,110**	-	**44,007**	-
Cost of plant closure (net of tax of $3,360,000)	**(3,714)**	-	**(1,227)**	-
Provision for warehouse closures	**-**	(2,610)	**-**	(2,610)
	$ 1,077	$(2,610)	**$50,651**	$(2,610)

15. Commitments and contingent liabilities

(a) Canfor is commited to make the following payments in respect of long-term operating leases of premises and equipment

	($000's)
1986	$ 4,581
1987	$ 3,822
1988	$ 3,356
1989	$ 3,065
1990	$ 2,722
Thereafter	$12,444

(b) Canfor has contracted for the use of railway cars for a stipulated sum before mileage allowances. As a result of mileage allowances earned in 1985 and 1984, the cost to Canfor under this contract was not significant. Commitments in respect of this contract, before mileage allowances, are as follows

	($000's)
1986	$ 3,198
1987	$ 2,680
1988	$ 2,192
1989	$ 1,970
1990	$ 1,069

(c) Arising from the sale of its 46 per cent interest in Yorkshire Trust Company, Canadian Forest Products Ltd. has agreed to indemnify the purchaser against any legal actions brought against Yorkshire Trust Company in respect of certain monies received by Yorkshire Trust Company. The maximum liability to Canadian Forest Products Ltd. is approximately $2,500,000. However, Canadian Forest Products Ltd. will not be liable under this indemnity if a settlement of $550,000 or less is reached.

16. Income taxes

Investment tax credits of $21,056,000 are available to reduce future income taxes payable and losses of $204,749,000 are available to reduce future taxable income as follows

Available for deduction	Investment tax credits	Losses Canada	U.S.	Total
	($000's)		($000's)	
1986	$ 7,684	$ 10,064	$ -	$ 10,064
1987	7,120	67,716	-	67,716
1988	942	-	-	-
1990	505	33,463	-	33,463
1991	1,660	26,249	-	26,249
1992	3,145	30,957	-	30,957
1995 and thereafter	-	-	36,300	36,300
	$21,056	$168,449	$36,300	$204,749

At December 31, 1985 depreciation included in the above losses is less than the amounts which can be claimed for income tax purposes by $76,199,000 which, together with the loss carry-forwards, is available to reduce future taxable income.

16. Income taxes continued
Capital losses of $889,000 are available to reduce capital gains in future years.

The potential income tax benefits associated with $15,746,000 of the above investment tax credits, capital losses and $75,279,000 of the above losses have not been recorded in Canfor's accounts.

The components of Canfor's income tax (expense) recovery for 1984 and 1985 are as follows

	1985	1984
	($000's)	
Loss before income taxes	**$(33,335)**	$(28,000)
Tax recovery at Canadian federal income tax rate of 46%	**$ 15,335**	$ 12,879
Canadian manufacturing and processing allowance	**(1,801)**	(744)
Provincial income taxes	**1,753**	1,255
Items not deductible for tax purposes	**(2,561)**	(2,562)
Inventory allowances	**2,617**	2,410
Tax losses not recognized	**-**	(11,445)
Recognition of tax losses of prior years	**10,987**	-
Oil and gas expenditures not allowed for tax purposes	**(47,061)**	-
Capital losses not deductible	**-**	(1,253)
Investment and scientific research credits	**-**	2,508
Income tax (expense) recovery	**$(20,731)**	$ 3,048
Effective tax rate	**(62.2)%**	10.9%

17. Segmented information
Information relating to Canfor's business on a segmented basis is set out in the statement of segmented information.

18. Related party transactions
Certain directors and private companies controlled by such directors, have periodically loaned funds to Canfor repayable on demand and bearing interest at the prime rate less 1%. During 1985, the maximum and minimum loaned to Canfor under this agreement were $16,800,000 and $14,499,000 respectively. At December 31, 1985 these loans amounted to $16,689,000 and are included in accounts payable and accrued liabilities.

19. Comparative figures
Certain 1984 comparative figures have been restated to conform with the 1985 presentation.

20. Subsequent event
On March 4, 1986 negotiations were concluded for the sale of the 50.38% interest held by a subsidiary company in Balco Industries Ltd. for net proceeds of $10.2 million. The sale is to close on April 30, 1986 and is subject to the approval of the Ministry of Forests.

21. Contributed surplus
During 1979, Canadian Forest Products Ltd. purchased for cancellation its outstanding 25,389 5% non-cumulative redeemable preferred shares of $100 par value at $10 per share which resulted in a gain of $2,285,000 which is included in earnings reinvested in the business.

SUBSIDIARY COMPANIES

Active

Wholly-owned
- Canadian Forest Products Ltd.
- Canadian Forest Products S.A.
- Canadian Forest Products Overseas Limited
- Canfor Limited
- Canfor Capital Limited
- Canfor Investments Ltd.
- Canfor Japan Corporation
- Canfor Properties Ltd.
- Canfor Pulp Sales Ltd.
- Canfor U.S.A. Corporation
- Intercontinental Pulp Company Ltd.
- Prince George Pulp and Paper Limited

Partially-owned
- Balco Industries Ltd. (50.38%) (Note 20)
- Westcoast Cellufibre Industries Ltd. (92.5%)

Partnerships
- Talka Forest Products (100%)
- Balco Reforestation Centre (100%)

Inactive

(including holding companies not carrying on active operations)
- British Columbia Shingles Limited
- Canadian Forest Products Sales Ltd.
- Canfor Investments Holdings Ltd.
- CFP Investments Ltd.
- Eburne Saw Mills Limited
- Howe Sound Pulp Company Ltd.
- Howe Sound Transportation Company Limited
- North Canadian Forest Industries (1981) Limited
- Pacific Veneer Company Limited

Statement of segmented information

Years ended December 31, 1985 and 1984
(in millions of dollars)

	Wood and wood products		Pulp and paper		Building materials		Consolidated	
	1985	1984	**1985**	1984	**1985**	1984	**1985**	1984 (Note 19)
By industry segment								
Net sales								
To external customers	**$287.8**	$264.1	**$254.3**	$262.0	**$541.7**	$503.4	**$1,083.8**	$1,029.5
To other segments	**168.2**	160.3	**-**	-	**-**	-		
	$456.0	$424.4	**$254.3**	$262.0	**$541.7**	$503.4		
Operating income (loss)	**$ 21.0**	$ 8.5	**$ (35.2)**	$ 14.6	**$ 3.2**	$ 1.4	**$ (11.0)**	$ 24.5
Non segment expenses - net							**(50.4)**	(48.3)
Net loss							**$ (61.4)**	$ (23.8)
Identifiable assets	**$277.3**	$307.9	**$405.6**	$376.7	**$107.3**	$111.8	**$ 790.2**	$ 796.4
Corporate assets							**121.4**	37.6
Investment in affiliates							**3.2**	65.6
Total assets							**$ 914.8**	$ 899.6
Depreciation, depletion and amortization	**$ 25.4**	$ 25.4	**$ 16.5**	$ 14.2	**$ 2.4**	$ 2.2		
Capital expenditures	**$ 24.6**	$ 15.8	**$ 32.0**	$ 23.4	**$ 2.5**	$ 1.3		

	Canada		United States		Consolidated	
	1985	1984	**1985**	1984	**1985**	1984
By geographic segment						
Net sales						
To external customers	**$863.8**	$832.0	**$220.0**	$197.5	**$1,083.8**	$1,029.5
To other segments	**20.5**	25.5	**-**	-		
Operating income (loss)	**(8.4)**	25.8	**(2.6)**	(1.3)	**(11.0)**	24.5
Identifiable assets	**750.0**	752.8	**40.2**	43.6	**790.2**	796.4
Depreciation, depletion and amortization	**43.1**	40.8	**1.2**	1.0		
Capital expenditures	**57.5**	39.5	**1.6**	1.0		

1. *Canfor operates in three industry segments: wood and wood products, pulp and paper, building materials.*
2. *Sales to other segments are accounted for at prices which approximate market.*
3. *Canadian sales include export sales amounting to $468 million in 1985 (1984 - $468 million).*

Seven year comparative review

	1985	1984	1983	1982	1981	1980	1979
Sales and income *(in millions of dollars)*							
Net sales	**$1,083.8**	$1,029.5	$995.1	$ 729.6	$710.5	$730.1	$734.0
Cost of products sold	**997.1**	908.4 (a)	881.3	700.5	615.9	564.7	522.3
Depreciation, depletion and amortization	**45.3**	45.1	48.6	45.0	39.1	34.8	32.7
Selling and administration	**65.0**	62.7 (a)	62.7	66.8	51.4	46.7	42.2
Interest expense	**39.2**	44.2	49.0	50.4	31.4	16.6	16.1
Other (income) expense	**(29.5)**	(2.9)(b)	(0.4)	0.8	(0.9)	(1.6)	-
Income (loss) before income taxes	**(33.3)**	(28.0)	(46.1)	(133.9)	(26.4)	68.9	120.7
Income tax (expense) recovery	**(20.7)**	3.1	9.9	46.0	8.1	(30.9)	(53.3)
Income (loss) before undernoted items	**(54.0)**	(24.9)	(36.2)	(87.9)	(18.3)	38.0	67.4
Equity in income (loss) of affiliated companies	**(8.2)**	1.4	(9.3)	(2.5)	20.2	17.1	13.1
Minority interests in subsidiaries	**(0.3)**	2.3	1.0	5.9	(1.5)	(5.0)	(5.9)
Income (loss) before extraordinary items	**(62.5)**	(21.2)	(44.5)	(84.5)	0.4	50.1	74.6
Extraordinary items	**1.1**	(2.6)	0.3	-	2.8	(0.8)	1.9
Net income (loss)	**(61.4)**	(23.8)	(44.2)	(84.5)	3.2	49.3	76.5
Preferred share dividends	**(6.7)**	(3.3)	(0.9)	(0.9)	(0.8)	(0.8)	(0.8)
Net income (loss) for common shareholders	**$ (68.1)**	$ (27.1)	$(45.1)	$ (85.4)	$ 2.4	$ 48.5	$ 75.7
Assets and capitalization *(in millions of dollars)*							
Working capital	**$ 1.3**	$ 48.5	$ 26.1	$(118.6)	$ 5.0	$142.5	$135.2
Long-term investments	**22.5**	73.1	73.9	84.9	88.6	71.2	54.4
Plant and equipment	**454.6**	448.7	451.6	479.5	423.6	313.3	300.2
Other assets and deferred charges	**41.1**	30.8	18.6	20.4	16.7	9.8	6.5
Net assets	**$ 519.5**	$ 601.1	$570.2	$ 466.2	$533.9	$536.8	$496.3
Long-term liabilities	**$ 198.8**	$ 231.0	$242.3	$ 223.6	$161.5	$163.6	$172.3
Deferred income taxes	**20.5**	0.6	1.6	15.5	60.7	64.4	64.7
Minority interests in subsidiaries	**8.2**	9.8	12.1	16.8	23.4	22.9	19.6
Preferred share capital	**86.0**	86.0	11.0	18.5	11.0	11.0	11.0
Common shareholders' equity	**206.0**	273.7	303.2	191.8	277.3	274.9	228.7
Total capitalization	**$ 519.5**	$ 601.1	$570.2	$ 466.2	$533.9	$536.8	$496.3
Additions to property, plant and equipment *(in millions of dollars)*	**$ 59.5**	$ 41.0	$ 22.6	$ 102.4	$ 84.9	$ 49.4	$ 47.6

Notes

(a) Certain 1984 expenses have been reclassified in conformity with the 1985 presentation.

(b) Other (income) expense for 1984 reflects the retroactive change regarding foreign exchange gains and losses on translation of U.S. dollar loans as described in note 1 to the financial statements.

(c) Percentages reflect the results of Swanson Lumber Co. Ltd. and Canfor U.S.A. Corporation (formerly Chandler Corporation) from August 1, 1981 and December 1, 1981 respectively.

	1985	1984	1983	1982	1981	1980	1979
Source (use) of cash							
(in millions of dollars)							
Operating activities	**$ 0.8**	$ 31.3	$ (33.7)	$ (49.0)	$ (26.8)	$ (5.9)	$114.9
Financing activities							
Long-term liabilities	**(43.2)**	(14.2)	17.8	65.2	(8.1)	(6.1)	(12.2)
Common and preferred shares	**-**	72.5	145.6	7.6	-	-	-
Dividends paid	**(6.8)**	(3.3)	(1.2)	(1.4)	(1.6)	(2.3)	(2.2)
	(50.0)	55.0	162.2	71.4	(9.7)	(8.4)	(14.4)
Investing activities							
Property, plant and equipment	**(59.5)**	(41.0)	(22.6)	(102.4)	(84.9)	(49.4)	(47.6)
Dividends received	**-**	1.1	1.5	3.2	3.5	2.3	1.5
Extraordinary items	**50.7**	(2.6)	-	-	1.3	(1.0)	6.2
Investment in subsidiaries	**-**	-	-	-	(61.3)	(1.7)	(1.5)
Other	**4.5**	(2.1)	(1.4)	(3.2)	1.0	(2.2)	(0.6)
	(4.3)	(44.6)	(22.5)	(102.4)	(140.4)	(52.0)	(42.0)
Decrease (increase) in net short-term indebtedness	**$(53.5)**	$ 41.7	$106.0	$(80.0)	$(176.9)	$(66.3)	$ 58.5
Financial statistics							
Return on capital employed - %	**(5.5)**	(0.1)	(2.5)	(7.8)	3.0	11.2	18.7
Return on common shareholders' equity - %	**(28.5)**	(9.3)	(18.2)	(36.4)	0.9	19.4	40.0
Ratio of current assets to current liabilities	**1.0:1**	1.2:1	1.1:1	0.7:1	1.0:1	2.0:1	2.0:1
Ratio of total debt to shareholders' equity	**61:39**	53:47	59:41	72:28	57:43	43:57	45:55
Production and other statistics							
Pulp - thousands of metric tons	**509.8**	456.8	493.2	441.5	418.5	526.0	499.7
Sack kraft paper - thousands of metric tons	**89.7**	80.0	85.0	88.5	77.7	97.0	96.6
Lumber - millions of board feet	**1,308.7**	1,223.3	1,164.6	768.2	711.4	749.5	783.7
Plywood - millions of square feet 3/8 inch equivalent	**281.0**	293.3	298.3	223.0	283.1	307.2	364.6
Hardboard - millions of square feet 3/8 inch equivalent	**55.9**	56.9	57.5	43.0	54.9	58.3	58.1
Shingles and shakes - thousands of squares	**117.4**	102.9	127.3	144.1	180.7	252.7	299.8
Sales by product line - % (c)							
Pulp and sack kraft paper	**24%**	25%	24%	33%	39%	43%	35%
Lumber	**27**	26	28	19	18	20	25
Plywood and hardboard	**7**	7	8	8	11	11	12
Shingles and shakes	**1**	1	1	1	2	2	3
Building materials purchased for resale	**39**	39	38	38	28	21	23
Miscellaneous	**2**	2	1	1	2	3	2
	100%	100%	100%	100%	100%	100%	100%
Sales by market - % (c)							
Canada	**37%**	35%	35%	37%	45%	40%	41%
United States	**41**	40	43	34	20	21	26
Europe	**11**	13	12	19	21	24	22
Far East	**9**	8	7	8	11	12	9
Other	**2**	4	3	2	3	3	2
	100%	100%	100%	100%	100%	100%	100%

For definitions of selected financial terms, please refer to page 33

Manufacturing and marketing facilities

Principal manufacturing facilities and annual capacities

PULP AND PAPER	Thousand tonnes
Howe Sound Pulp Division	
Port Mellon, B.C.	
kraft pulp	205
Prince George Pulp and Paper Limited	
Prince George, B.C.	
kraft pulp	170
sack kraft paper	100
Intercontinental Pulp Company Ltd.	
Prince George, B.C.	
kraft pulp	220
	695

LUMBER	Million board feet
Eburne Saw Mills Division	
Vancouver, B.C.	150
Westcoast Cellufibre Industries Ltd.	
Vancouver, B.C.	32
Takla Division	
Fort St. James, B.C.	180
Isle Pierre, B.C.	86
Chetwynd Division	
Chetwynd, B.C.	144
Fort St. John Division	
Fort St. John, B.C.	124
Balco Industries Ltd.	
Louis Creek, B.C.	81*
Kamloops, B.C.	65*
Merritt, B.C.	74*
Alberta Operations	
Grande Prairie, Alberta	112
High Level, Alberta	208
Hines Creek, Alberta	63
	1319

*Subject to certain conditions and approvals, Canfor's interest in Balco will be sold effective April 30, 1986.

PANEL PRODUCTS	Million square feet ⅜ inch equivalent
New Westminster Hardboard Division	
New Westminster, B.C.	
hardboard	69
Balco Industries Ltd.	
Kamloops, B.C.	
plywood	114*
Alberta Operations	
Grande Prairie, Alberta	
plywood	67
	250

SHINGLES	Thousand roof squares
Huntting-Merritt Shingle Division	
Vancouver, B.C.	
shingles	128

OTHER

Canfor's United States subsidiary, Canfor U.S.A. Corporation, produces structural trusses, remanufactured lumber items and building specialty products. Manufacturing facilities are situated in the following locations:
Albany, Oregon
Woodland, California
Meridian, Idaho
Halstead, Kansas
Fort Worth, Texas

NOTE
Pulp and paper capacities are based on continuous operation for 340 days per year. Hardboard capacity is based on continuous operation for 345 days per year. Capacities for other wood products assume 240 operating days per year and two shifts per day except for the Huntting-Merritt capacity which reflects one shift per day. In most cases, the capacities differ from previously published figures because of changes in mill facilities, log supply and product mix.

Sales and distribution facilities

PULP AND PAPER SALES OFFICES

Vancouver, B.C.
Montreal, Quebec
London, England
Brussels, Belgium
Tokyo, Japan

In addition, Canfor is represented by pulp sales agents serving other major markets around the world.

LUMBER AND SHINGLE SALES OFFICE

Vancouver, B.C.

WATERBORNE WOOD PRODUCTS SALES

Sales of lumber, panel products, shingles and shakes to markets reached by ship are made through Seaboard Lumber Sales Company Limited, a worldwide wood products marketing consortium of which Canfor is a member.

WHOLESALE BUILDING MATERIALS DISTRIBUTION CENTRES – CANADA

Western Region
Burnaby, B.C.
Kelowna, B.C.
Nanaimo, B.C.
Calgary, Alberta
Edmonton, Alberta
Grande Prairie, Alberta
Saskatoon, Saskatchewan
Winnipeg, Manitoba

Central Region
Toronto, Ontario
London, Ontario
North Bay, Ontario
Ottawa, Ontario
Peterborough, Ontario
Montreal, Quebec
Quebec City, Quebec

Atlantic Region
Dartmouth, Nova Scotia
Sydney, Nova Scotia
Fredericton, New Brunswick
Moncton, New Brunswick
Deer Lake, Newfoundland
St. John's, Newfoundland

LUMBER SALES AND DISTRIBUTION FACILITIES – UNITED STATES

Albany, Oregon
Woodland, California
Boise, Idaho
Halstead, Kansas
Fort Worth, Texas
Manchester, New Hampshire

Canfor operates this full gauge logging railroad at Englewood, on Vancouver Island.

Corporate information†

Directors

A. Gordon Armstrong[1,2]
Senior Vice-President, Finance
Canfor Corporation
Vancouver, B.C.

Peter J.G. Bentley[1,3]
Chairman and Chief Executive Officer
Canfor Corporation
Vancouver, B.C.

Roy A. Bickell[1]
President and Chief Operating Officer
Canfor Corporation
Vancouver, B.C.

Ronald L. Cliff[1,2,3]
Chairman of the Board
Inland Natural Gas Co. Ltd.
Vancouver, B.C.

C. William Daniel[2]
Corporate Director
Toronto, Ontario

Mark H. Gunther[1,3]
Vice-Chairman
Canfor Corporation
Vancouver, B.C.

Joseph B. Jarvis[1]
Corporate Director
Vancouver, B.C.

Peter A. Lusztig[2]
Dean, Faculty of Commerce and Business Administration
University of British Columbia
Vancouver, B.C.

Ronald N. Mannix[2]
Chairman
Manalta Coal Ltd.
Calgary, Alberta

John G. Prentice[1]
Co-founder
Canfor Corporation
Vancouver, B.C.

Committees of the Board

[1]Executive Committee
[2]Audit Committee
[3]Compensation Committee

Officers

Peter J.G. Bentley
Chairman and Chief Executive Officer

Mark H. Gunther
Vice-Chairman

Roy A. Bickell
President and Chief Operating Officer

A. Gordon Armstrong
Senior Vice-President, Finance

James D. Earle
Vice-President, Corporate Services

Douglas C. Edwards
Vice-President, Human Resources

W. Bert Gayle
Vice-President, Coastal Operations

G. Brian Hobson
Vice-President and Corporate Controller

William I. Hughes
Vice-President, Pulp and Paper Manufacturing

Wayne B. Jacques
Vice-President, Alberta Operations

Richard F. Weinman
Vice-President and Secretary

Ray B. Haslam
Deputy Corporate Controller

†As at March 14, 1986

Auditors

Price Waterhouse
Vancouver, B.C.

Head office

3000 - Four Bentall Centre
1055 Dunsmuir Street
Vancouver, B.C.
Telephone: (604) 661-5241
Telex: 04-53338

Postal address

2800 - 1055 Dunsmuir Street
Post Office Box 49420
Bentall Postal Station
Vancouver, B.C. Canada
V7X 1B5

Principal wholly-owned subsidiaries

Canadian Forest Products Ltd.
Canfor Limited
Canfor U.S.A. Corporation
Intercontinental Pulp Company Ltd.
Prince George Pulp and Paper Limited

Interest in other companies

Balco Industries Ltd. (50.38%)*
B.C. Chemicals Ltd. (50%)
Westcoast Cellufibre Industries Ltd. (92.5%)

*Subject to certain conditions and approvals, Canfor's interest in Balco will be sold effective April 30, 1986.

Shareholder information

Annual meeting
The annual meeting of the shareholders of the Company will be held in the British Room, Hotel Vancouver, 900 West Georgia Street, Vancouver, B.C. on Monday, April 28, 1986, at 11:00 a.m.

Transfer agent and registrar
The Royal Trust Company
Vancouver, Calgary, Regina, Winnipeg, Toronto, Montreal and Halifax

Shares listed
Toronto Stock Exchange
(common and preferred shares)
Vancouver Stock Exchange
(common shares only)
Symbol: CFP

1985 price range of common shares
High: $13 ⅞ per share
Low: $ 7 ⅜ per share

Number of common shares outstanding
18,575,475 shares,
as at December 31, 1985

Number of common shareholders
1,128 shareholders,
as at December 31, 1985

Definitions of selected financial terms

Net income per common share is the net income for the year, less provision for preferred dividends in the year, divided by the number of common shares outstanding at the end of the year.

Cash flow from operations per common share is the cash flow from operations for the year, less provision for preferred dividends in the year, divided by the number of common shares outstanding at the end of the year.

Common shareholders' equity per common share is the shareholders' equity excluding preferred share capital at the end of the year, divided by the common shares outstanding at the end of the year.

Total capitalization is comprised of long-term liabilities, deferred income taxes, minority interests in subsidiaries and shareholders' equity.

Capital employed consists of the funds invested or retained in the Company in the form of shares or liabilities. It is composed of unpresented cheques, current bank loans (net of cash and temporary investments), current portion of long-term debt, long-term debt, deferred income taxes, minority interests in subsidiaries and shareholders' equity. Long-term liabilities such as deferred reforestation costs and unfunded pension and retirement benefits are specifically excluded because they do not represent borrowed funds or funds invested by shareholders.

Return on capital employed is equal to net income plus interest, after tax, divided by the average of the capital employed as at the beginning and end of the year.

Return on common shareholders' equity is equal to net income for the year, less provision for preferred dividends in the year, divided by the average of the shareholders' equity excluding preferred share capital at the beginning and end of the year.

Number of employees at year-end is the actual number of employees, salaried and hourly, full-time and part-time, permanent and temporary, who are considered as employees of the Company. This includes employees who are on vacation, leave of absence, workers' compensation, long-term disability or who are laid off as the result of temporary shut down.

Canfor Corporation

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Bentall Postal Station

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Telephone (604) 661-5241

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